6

Capital Flight through Islamic Managed Funds

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In much of the Islamic World finance is asymmetric, as private wealth is, at least in part, generated locally but then invested in Western markets, a phenomenon which is referred to as capital flight. In contrast, Muslim governments mostly fail to raise sufficient revenue to cover their expenditures, and as a result they become dependent on international borrowing to fund their deficits. There is, in other words, varying degrees of private affluence and this is by no means confined to the oil-exporting states of the Gulf; at the same time there is public squalor and run down and decaying public services. To what extent can Islamic finance help solve these imbalances? Is the application of *shari'a* law a help or hindrance to the development of domestic financial intermediation and national financial markets in Muslim countries?

As Islamic finance is by definition primarily of concern to Muslims, its adoption might be expected to result in capital markets of the Islamic World becoming segmented from global markets based on conventional finance. Indeed, Islamic markets might be ghettoised, which might imply losing out on some of the potential gains from globalisation, such as economies of scale in financing and lower transactions costs. On the other hand, global capitalism is often viewed as exploitative from a Muslim developing country perspective, with the gains from international financial integration unfairly distributed.

In this chapter the direction of Islamic investment is analysed. Financial flows through the Islamic Development Bank (IDB) are examined, as these involve recycling within the Muslim World, but the main focus is on outward portfolio investment flows, especially those through managed funds. There is relatively little Islamic foreign direct investment, reflecting the failure of indigenous multinational companies to develop in most Muslim countries where governments are resistant to competing local centres of economic power beyond their control. The Islamic managed fund industry remains modest in scale, with assets worth less than $10 billion, but it is qualitatively significant, as its experience demonstrates the constraints in redirecting Muslim capital flows to emerging Muslim markets.

ISLAMIC CAPITALISTS AND THE STATE IN THE MIDDLE EAST

Governments in the Middle East have not only failed to attract significant amounts of Western capital through foreign direct investment, they have also been unwilling and unable to create the conditions for domestic Islamic capital accumulation. Ironically, it is in the much more liberal conditions of Western markets that Islamic capital is starting to flourish, and where most Islamic wealth creation is occurring as a result of outward portfolio investments. Domestic economic liberalisation in the Middle East is a necessary precondition for capital flight to be reversed, and for Islamic investors to feel that they are stakeholders in their own economies, rather than being globally footloose and nationally rootless. Governments and Islamic investors both recognise the links between money and political power, but while governments in the Middle East use their influence to monopolise resources, Islamic investors need more diverse, competitive structures and the economic space to pursue their own entrepreneurial activities. In this respect, their needs are no different than those of Western capitalists.

Though frustrated by their own governments, a number of leading Muslim businessmen have nevertheless profited from agency rights they have obtained from the state, and enjoyed its protection of their monopoly privileges to initiate their wealth. Any patronage system, partly because of its inherent inefficiencies, is limited in its ability to transform millionaires into billionaires. For more serious wealth accumulation Islamic investors have therefore had to look beyond the state at the global marketplace, hence the trend towards capital flight. Saad Eddin Ibrahim referred to Saudi Arabian entrepreneurs as 'lumpen capitalists', believing that by the 1970s, as a result of the oil boom, they no longer were traditional merchants, but yet at the same time they had not become entrepreneurial in the Western sense of taking risks with their capital.[1] Nevertheless, far from being a parasite and reaping profits without work, Ibrahim sees the Saudi entrepreneur as a 'cultural broker par excellence', interpreting the socio-political environment of the Kingdom to the outside world and vice versa.[2]

Contemporary Islamic capitalists are also cultural brokers, in the sense of acting as intermediaries between societies that are guided by *shari'a* law and the wider global economy that is largely based on Western modes of capital accumulation. Whereas in the 1970s and early 1980s, when there was much profit to be made in government contracts, especially in the Gulf, the Islamic capitalists relied on the state, by the 1990s, with a weakening economic role for the state, Islamic capitalists were seeking alternatives. One was to look at investment opportunities in booming Western markets, and profit from channelling capital – both their own and that of others for whom they acted as intermediaries – towards these markets. Labelling such activity involving capital flight as Islamic finance made it more acceptable, especially if respected *shari'a* scholars could be persuaded to endorse the practice.

MUSLIM BELIEFS AS A CONDITIONING FACTOR IN INVESTMENT BEHAVIOUR

A religion can get its teachings respected and enforced either by having government acting on its behalf or by persuading individual believers to act in accordance with their faith, or by some mixture of the two. Political Islamists advocate the former, by having governments enforce *shari'a* law in all areas of human activity, including the financial sphere, as with Iran's Islamic banking laws of 1983. An alternative, and arguably preferable, approach is to support the provision of Islamic financing facilities to ensure that individual believers can manage their finances in accordance with Islamic teaching, while at the same time permitting conventional financial institutions to continue functioning. Such a dual system is found in the majority of countries with substantial Muslim populations, with the growth of Islamic finance driven by market forces rather than government dictate. In such a dual system, whether to use Islamic financial services is a matter of personal moral choice in a marketplace where there are differentiated products, some with ethical as well as purely financial characteristics. There are many parallels here between the ethical finance industry and Islamic financing, with marketing using moral suasion to appeal to conscience and stressing social benefits rather than simply private returns.

Muslim investors could be better served by Islamic economists and finance specialists than they have been up to the time of writing. In their discussion of Islamic economic agents, Farhad Nomani and Ali Rahnema focus on consumer behaviour, the stress being on moderation, but they remain silent on investor behaviour.[3] Ibrahim Warde does not treat the behaviour of savers and investors explicitly, although he does discuss problems of moral hazard in an Islamic context in relation to debt,[4] and there is a brief acknowledgement of the difficulties investors face in emerging markets.[5] The only discussion of Islamic investment funds has been by Muhammad Taqi Usmani, who serves as *shari'a* advisor to numerous Islamic banks and conventional banks offering Islamic financing and asset-management facilities.[6]

Although the message of Islam is universal, most have taken national rather than internationalist perspectives, and have little to say about issues such as capital flight. Umer Chapra[7] refers to capital flight from Iran as one factor whose legacy adversely affected the Islamic banking system, but there is no discussion of country risk perceptions as a cause of capital flight. Chapra also correctly diagnoses the causes of the Asian financial crisis of 1997 as the mismatch between reliance on short-term dollar-denominated debt and longer-term lending in local currencies, which affected Muslim countries such as Malaysia and Indonesia, but there is no attempt to provide a specifically Islamic critique.[8] There is, for example, the issue of whether government imposition of capital controls is justified. On the one hand, such controls may prevent Muslims, admittedly the wealthy, from exporting their capital and earning potentially higher and less risky returns. On the other hand, controls may help maintain the value of the currency, keeping down the price of imported foodstuffs and other basic commodities for the poor, and ensure that local savings at least are deployed into national investments.

There has also been surprisingly little written by Islamic economists on economic cooperation between Muslim countries. Although Munawar Iqbal expressed his frustration that surplus funds from some Muslim countries and their citizens were not deployed in other Muslim countries lacking resources for development, he did not analyse why this was the case.[9] Similarly, Masudul Alam Choudhury applied the principles of *taweed* and brotherhood to Islamic economic cooperation, but failed to suggest how such a programme of cooperation could be implemented in any practical sense apart from in the sphere of Islamic trade financing.[10]

DEVELOPMENT ASSISTANCE AS A MEANS OF PROPAGATING ISLAMIC LAW

Islamic finance was viewed as a potential unifying factor by the Muslim governments meeting under the auspices of the Organisation of the Islamic Conference (OIC) in 1973 and subsequently. The OIC was established as a forum for political dialogue between Muslim states on matters of mutual interest, including relations with the West and the rights of Muslims in Palestine. Some of its proponents, notably the government of Saudi Arabia, saw it as an alternative to the secular Arab League, which had been used, wholly unsuccessfully by Nasser, as a vehicle for Arab unity, including economic unity. Rather than focusing on trade relations, as the Arab League had done, the OIC in the economic sphere emphasised financial relations, partly because trade between Muslim states was only a small proportion of their total trade, most of which was with the West, and it was recognised from the ill-fated experiences of the Arab Common Market and the Arab Economic Unity Council, that it would be difficult to change this reality.

With the oil price increases of 1973–74, Saudi Arabia had vastly increased financial resources at its disposal, which could potentially be used to further the regime's international relations objectives, namely secure recognition as the guardian of the holy sites of Islam and counter criticism from both Arab nationalists and political Islamists that it was too closely involved with the

United States. There was a continuing tension between the Kingdom's dependence on Western oil markets and the United States as a military protector, and its desire for legitimacy as a defender of the *shari'a* law in the eyes of both Muslim governments and Islamist groups, at home and abroad, who were at best openly suspicious of Western and Zionist intentions, and, more often, virulently opposed to western secularist values and the threat they posed to the Islamic World. In the majority of Muslim countries, governments either ignored or suppressed such Islamist groups, but Saudi Arabia, a regime based on Wahabbi credentials, could not embark on a policy of suppression, especially as many of its own citizens shared the views of these Islamist groups, and, in some cases, were prepared to offer them financial backing in their struggles with their own regimes or the West.

Egypt depicted the 1973 war as a victory for the Arab cause due to the efforts of its soldiers in crossing the Suez Canal and establishing a bridgehead in Sinai. Sadat argued that the oil price increases, which benefited Saudi Arabia but not Egypt, had come about through its sacrifices, and therefore it was entitled to financial recompense. Other Arab states without oil, notably Jordan and the Sudan, asserted that they were being forced to pay more for oil imports from their Arab neighbours, and more distant Muslim states such as Pakistan and Malaysia voiced similar concerns. Saudi Arabia's response was to support the founding of the Islamic Development Bank (IDB), with itself as the major shareholder.

The remit of the IDB, which was established in 1975, was to foster economic development and social progress in Muslim countries in accordance with the principles of the *shari'a*. The bank has financed trade within the Islamic World and numerous projects in Muslim countries, but over a quarter of a century of its impact has been, at best, limited. Funds have been recycled within the Muslim World, but the results were modest in relation to the aspirations of the OIC. The initial paid-up capital was only $750 million, of which Saudi Arabia subscribed $200 million, a modest sum in relation to its financial resources at that time.[11] By 2000, the paid-up capital of the IDB was almost $8 billion, which seems impressive but is modest in relation to the financial resources of major global organizations such as the International Monetary Fund, which is capitalised at $290 billion. Saudi Arabia's share of IDB capital is $2 billion, a substantial but by no means overwhelming commitment.

The IDB does not finance projects in Saudi Arabia, but the Kingdom has benefited indirectly, as almost one-third of the trade financing by the IDB has been for oil imports, with one of the original aims of the new institution being to assist poorer Muslim countries without oil resources to pay for their essential imports, especially after the oil price rises of 1973–74. The IDB has approved trade financing arrangements worth over $15 billion and project finance valued at more than $6.5 billion, as well as 340 technical assistance operations.[12] In recent years, trade financing has involved a diverse range of commodities, including industrial intermediate goods ($3.2 billion), vegetable oil ($900 million), refined petroleum products ($769 million), fertilisers, phosphoric acid and potash ($465 million), rice and wheat ($459 million) and cotton ($367 million). Although these figures seem large, they refer to cumulative financing over the 1975–99 period, which averages out to approximately $1 billion per annum, a much smaller amount. By comparison, World Bank funding amounts to $17 billion per annum.

The IDB attempts to set an example by using *shari'a*-compliant financing methods, with much of the trade financing being offered through *murabaha*, mark-up funding with the bank purchasing goods on behalf of the importer and reselling them at a premium. Project finance has become increasingly important for the IDB in recent years, with much of the funding provided through leasing, (*ijara*) hire purchase (*ijara wa-iqtina*) and advance purchase financing (*istisna*). Almost one-third of project finance has been for public utilities such as power generation plants, electricity transmission, and water treatment and distribution facilities, with over $1.5 billion used in this way between 1995 and 1999. Social projects account for a further quarter of the total, including schools and hospitals, with around $1.2 billion disbursed over the same period. Other project funding at this time was for transport and communications ($1 billion), industry ($850 million) and agriculture ($800 million).

With over twenty-five years' operational experience, it is appropriate to ask to what extent the IDB has achieved the objectives of its founders, and Saudi Arabia in particular. Clearly, with Muslim countries experiencing some of the lowest growth rates in the developing world, it has not been successful in fostering economic development. Nor has it achieved much in terms of encouraging the application of Islamic law in the field of commerce; indeed, some of the states it has supported generously, notably Turkey, at least until the 2002 elections became more secularist than ever, although it has permitted the special finance houses to operate, two of which, Al-Baraka Türk and Faisal Finance, are backed from Saudi Arabia. There have also been some benefits to Saudi interests in Egypt, notably with the establishment of the Faisal Islamic Bank of Egypt, although arguably this more accommodating attitude towards Islamic finance was more opportunistic on the part of the Egyptian government rather than because of any deeper commitment. More significantly, the IDB has acted as a vehicle for the improvement of Saudi–Iranian relations since 1997, with Iran subscribing an additional $1 billion to the bank as a concrete indication of its willingness to participate in pan-Islamic World projects in collaboration rather than in competition with its Arab neighbours.

The other important OIC organisation is the *Fiqh* Academy, based in Jeddah, which brings together experts in Islamic jurisprudence. Since 1986 it meets annually shortly after the end of Ramadan, the sixteenth meeting being held in Mecca from 5 to 10 January 2002.[13] Since its inception it has become arguably the most authoritative source of modern Islamic law and its *fatwas* are more widely accepted than those from any other source, at least in the Sunni Muslim World. This is partly because of the wide range of those represented at the meetings and the specialists in disciplines such as medicine and economics, who are on the fringes but often called to give expert advice. The resultant *fatwas* are respected, as not only are the rulings published but also the reasoning behind them. Consequently, the authority of alternative sources of Islamic law, notably Al Ahzar in Cairo, has tended to be undermined. This has not so much enhanced the position of the Saudi Arabian government in relation to the Egyptian authorities, but rather strengthened pan-Islamic law in relation to state laws.

THE EXTENT OF CAPITAL FLIGHT

The lower-income Muslim countries in the Arab World, South Asia and South East Asia all maintain controls on capital movements, with varying degrees of restriction on foreign exchange transfers to fund investment abroad. Capital still moves abroad illegally, usually either through black market foreign exchange dealings, or the retention of hard currency earnings by exporters or migrant workers. These earnings are subsequently invested abroad rather than remitted into domestic currency. Due to their illegal nature, it is difficult to estimate the extent of such transactions, although they are undoubtedly a significant source of capital flight.

Saudi Arabia and the Gulf states have no restrictions on capital movements by local nationals, and their currencies are freely convertible and stable against the United States dollar. As a consequence, substantial amounts of private wealth are held abroad, as Table 6.1 shows, drawing on Saudi American Bank

Table 6.1: Saudi and Gulf high net worth individual wealth abroad

	Amount $ billion	*Individuals*	*Average per individual $ million*
Saudi Arabia	700	85,000	8.235
UAE	266	60,000	4.433
Kuwait	163	40,000	4.075
Other Gulf	65	15,000	4.333
Total	1,194	200,000	5.970

Source: Saudi American Bank 2001 extrapolations from 1995 Merrill Lynch/Gemini Consulting Study.

estimates.[14] The funds are mostly held in the United States, with perhaps over a quarter in Europe and the remainder in Asian markets, mainly Japan and Hong Kong. Funds are invested in equities, managed funds, government and corporate bonds, and residential and commercial property. The weighting of each investor's portfolio is determined by attitudes towards risk, financial market conditions and whether the fundholder is more concerned with receiving income or capital gains. Most of the investments are managed professionally, either through private banking or fund management groups.

In most respects, the investment behaviour of the estimated 200,000 high net worth individuals from Saudi Arabia and the Gulf is little different from that of their counterparts elsewhere. Their aim is to generate income and wealth from their assets which benefits their families and themselves, where the funds are invested being a less important consideration. How funds are invested is for many more crucial than where, as most Saudi Arabian and Gulf citizens, like Muslims elsewhere, are concerned about deriving income from interest, even though for the majority this concern does not translate into positive action. Some cleanse or purify interest income by donating it to charitable causes; others invest part of their funds in a *shari'a*-compliant manner to ease their conscience, while investing the remainder conventionally. In this respect, Islamic investors are little different to Western ethical investors, who tend to adopt a partial approach rather than deploying all their funds ethically.

The professional advisors involved in the management of the assets of Saudi Arabian and Gulf investors are often instructed to place the funds in accordance with *shari'a* law. It is these instructions that have resulted in the growth of Islamic banking activity in international markets, notably London and Bahrain, where leading Western banks such as HSBC, Deutsche Bank, ABM Amro, Citibank Group and Merrill Lynch all offer Islamic financial products. Private banks are prepared to construct bespoke Islamic portfolios on their client's behalf, if they have sufficient funds to invest to justify the cost. Where portfolios include equities, investment in companies involved in alcohol production or distribution or pork products are excluded, as indeed are conventional banks because of their interest dealings, even though paradoxically the same banks are managing the funds. For clients with lesser amounts of funds to invest, Islamic mutual funds, the focus here, have become an acceptable alternative. Such 'off the peg' Islamic investment appeals to those who have insufficient funds to qualify for private banking services, or who do not wish to pay the fees levied for a personalised 'tailored' product.

THE GLOBAL ORIENTATION OF ISLAMIC FUNDS

As of December 2001, there were 105 Islamic mutual funds, of which 86 were equity funds and 16 were balanced or secured funds, the other three being Islamic bond funds offered by Malaysian institutions.[15] The funds are classified geographically, as Table 6.2 shows, with a preponderance of global equity funds, although North American, Asian and emerging-market funds are also significant. As most of the global equity funds hold over half their assets in the United States, the extent to which they are truly global is debatable.

This geographical emphasis is both a reflection of equity market realities and client perceptions. There are two major client groups, the dominant group being those residing in the Gulf, where there are no capital controls, as already indicated, and investors are free to deploy their funds anywhere. The second group is investors in Malaysia, Indonesia and to a lesser extent those in other Asian countries, who are primarily focused on their domestic markets, although some have access to dollar funds which they wish to invest globally.

There are also two factors explaining the direction of portfolio investment flows of fund management groups offering designated Islamic products. The first relates to the supply of available equity stock, which can be used to construct an equity portfolio to serve clients' needs. As dollar-denominated stock is sought, the United States is clearly the prime destination for portfolio flows, followed by dollar-denominated stock quoted in other markets. The second relates to the demand side, and that is ultimately a marketing issue. Clients are looking for a global spread, with a concentration on North America, as they know that stock quoted on the New York Stock Exchange and NASDEQ account for over one-third of the global total by stock value. Despite the setbacks of 2001 and 2002, there is an underlying confidence in the long-term resilience of the North American markets.

Table 6.2: Categorisation of Islamic mutual funds

Type	*Number*
Global	33
North America	10
European	5
Asian	18
Emerging market	12
Small companies and technology	8
Balanced or secured funds	16
Islamic bonds	3

Source: www.failaka.com/Funds.html

Table 6.3: Economic indicators for Muslim countries

Country	*GNI $ billion 1999*	*GNI, ppp $ per capita 1999*	*Growth % 1990–99*	*Investment % GDP 1999*	*Debt $ billion 1999*
Egypt	86.5	3,460	2.4	23	30.4
Indonesia	125.0	2,660	3.0	24	150.1
Iran	113.7	5,520	1.9	18	10.3
Jordan	7.7	3,880	1.1	21	8.9
Malaysia	76.9	7,640	4.7	22	45.9
Morocco	33.7	3,320	0.4	24	19.1
Pakistan	62.9	1,860	1.3	15	34.4
Saudi Arabia	139.4	11,050	–1.1	19	N/A
Syria	15.1	3,450	2.7	29	22.4
Turkey	186.5	6,440	2.2	23	101.8
UK	1,403.8	22,220	2.1	18	N/A
US	8,879.5	31,910	2.0	20	N/A

Source: World Bank, 2001.
Note: GNI is gross national income, GNP is gross domestic product and N/A is not available.

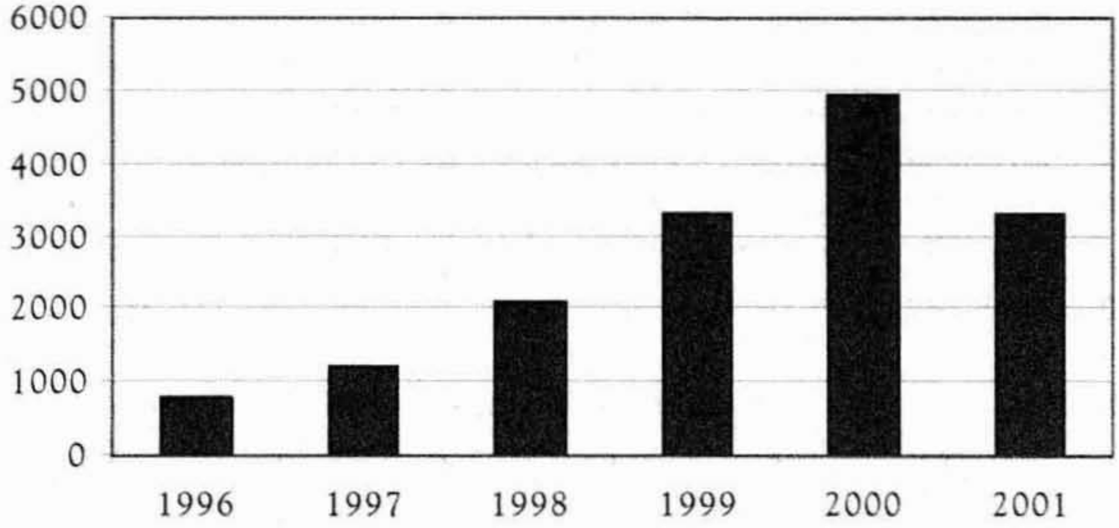
Islamic-designated funds might be expected to invest a greater proportion of their funds in the financial markets of Muslim countries – indeed, they are often criticised for not being more proactive in promoting inter-Islamic World portfolio investment flows, and taking money out, rather than directing it to cement greater Muslim World economic solidarity. One problem is that the restricted size of stock markets in Muslim countries reduces their absorptive capacity. Simply pouring more funds into these markets would increases price-earnings ratios to levels that could not be sustained.[16]

Another problem is country risk uncertainties, not so much with political stability but rather with inconsistent and poorly implemented macroeconomic policies that have failed to create the conditions for sustained economic growth. Ultimately, the returns in financial markets reflect economic success and, as Table 6.3 shows, many of the economies of the Islamic World are extremely small, with very low growth rates and high levels of debt.

Even the United Kingdom's economy is over seven times the size of Turkey's, the largest in the Muslim World, a factor that is inevitably reflected in the size of its capital market. Furthermore, although the economic growth rate in the UK and the US was not especially impressive for the 1990–99 period, and even less impressive subsequently, the absolute increase in gross national income per capita from a higher base is numerically much greater than that from a lower base.

Global market volatility has inevitably had an adverse impact on Islamic funds. Conditions in major international equity markets, especially the New York

Figure 6.1: Total Islamic fund assets, year end, $ million



Source: Failaka International, *www.failaka.com* 2002.

Stock Exchange and NASDEQ, have been difficult since the spring of 2000, with the prices of overvalued high technology stock falling first, but then a more widespread retreat as the United States economy slowed down, and then a further across-the-board fall since the events of 11 September 2001 and the move of the American economy into recession. This has adversely affected the performance of global Islamic funds, which, as already indicated, are heavily exposed to US markets, and technology stock in particular. One estimate suggests the value of assets in Islamic funds has fallen from $5 billion in early 2000 to $3.3 billion by February 2002, as Figure 6.1 shows.[17] Even those Islamic funds exposed to other markets have been adversely affected in so far as stock prices in these markets have been correlated with those on Wall Street. There are exceptions, notably Saudi Arabian stocks, which have performed well, partly due to

Table 6.4: Islamic funds

Year	*Number*	*Year*	*Number*
1993	9	1998	62
1994	13	1999	78
1995	17	2000	85
1996	29	2001	98
1997	41	2002	105

Source: Failaka International, *www.failaka.com* 2002.

some repatriation of funds after 11 September 2001, but even Malaysian equity prices have moved in line with those in North America and Japan.

Of course, the post-millennium setback in stock prices mirrors other similar falls in the past, and many predict recovery by 2003. The record number of Islamic funds, as Table 6.4 shows, illustrates confidence in the future, although there has been a slowdown in new offerings as market uncertainty has deterred banks and fund management groups from launching as many Islamic funds. The seven funds launched in 2001 include two of the Malaysian Islamic bond funds and other new fund launches have focused on those where capital is at less risk, rather than on equity growth.

INTERNATIONAL MANAGEMENT AND SPONSORSHIP OF ISLAMIC FUNDS

Most Islamic funds focus on clients from the Gulf and, to a lesser extent, Malaysia. There are relatively few investors of high net worth or even those in the upper-middle-income category in other Muslim countries, and those who are in this group tend to have international earnings which can be invested and managed anywhere in the world, rather than through domestic financial institutions. Therefore, this category of footloose rich from the Muslim World can be targeted from London, Geneva or New York as easily as from their home bases. There are also relatively few higher-income earners who are potential investors in Islamic funds amongst the Muslim populations of most Western countries, with the possible exception of a minority of Muslims in the United Kingdom and the United States. Many of the more wealthy Muslims in the West are closely integrated into their adopted countries and simply use conventional financing facilities, having relatively little interest in Islamic finance.

Some promoters of Islamic funds, notably the international banks, have targeted the very wealthy and offered managed funds as a lower-cost alternative to a privately managed portfolio, which is more labour intensive to monitor and administer, overheads that can only be justified for those with at least $250,000 to invest. Lower thresholds can be offered for managed funds, as they are administered and monitored on a pooled basis, with the costs spread over several, or in the case of popular funds, many clients. In the Gulf, the target clients for Islamic fund promoters are not only the most wealthy segments of society, but rather upper-middle-income bank clients who want additional avenues for their capital beyond savings deposits. Such deposits are not well-regarded by the devout, as they feel obliged to purify their income by giving away any interest-based returns to charity. Their main hesitation with respect to managed funds is the knowledge that their capital is at risk, even though in the medium to long term the hope is for capital gains.

The top twelve leading Islamic managed funds are listed in Table 6.5, with the Al-Ahli Global Trading Equity Fund offered by the National Commercial

Table 6.5: Leading Islamic managed funds

Fund	*Promoter*	*Established*	*Minimum investment*	*Annual fee %*	*Total assets $ million*
Al-Ahli Global Trading Equity	National Commercial Bank	1995	$2,000	1.75	640.0
Alfanar Investment Holdings	Permal Asset Management	1997	$5,000	2.00	171.0
Takaful Global Fund	Keppel Insurance	1995	S$4,000	1.50	94.3
Al-Dar World Equities	Pictet & Cie	1998	$100,000	1.50	45.9
UBS Islamic Fund – Global Equities	UBS Islamic Fund Management	2000	$100,000	2.04	33.8
Citi Global Portfolio	Citi Islamic Investment Bank	1997	$10,000	1.81	33.8
Al-Rajhi Global Equity	Al-Rajhi Banking and Investment Corporation	1996	50 shares	1.5	30.0
Dow Jones Islamic Index	Wafra Investment/ Al Tawfeeq	1999	$10,000	1.5	22.5
SAMBA Global Equity	SAMBA Capital Management	1999	$2,000	2.15	16.0
Al-Bait Global Equity	Securities House	2000	$50,000	1.75	15.0
Al-Baraka Global Equity	Al-Baraka Investment Bank	1997	$25,000	1.50	11.1
Global Equity 2000 Sub Fund	First Investment Company	2000	$10,000	1.50	11.0

Source: Failaka International, *www.failaka.com* 2002.

Bank of Saudi Arabia being by far the largest. This is a retail fund with a only a modest minimum investment of $2,000 required, the target market being National Commercial Bank account-holders, including those with limited incomes. Permal Asset Management of London promotes Alfanar Investment Holdings mainly to wealthy private investors in the Gulf, its link with Saudi Economic and Development Company (SEDCO) generating most of its business. Keppel Insurance of Singapore markets the Takaful Global Fund, the target group being wealthy investors from Brunei, Malaysia and Indonesia. The funds promoted by Pictet & Cie and the UBS from Geneva are aimed at private banking clients of high net worth, with minimum investments required of $100,000. Several Islamic banks in the Gulf, in return for a booking fee, recommend these funds.

Table 6.6: Five largest Islamic fund managers

Manager	*Country*	*Assets, $ million*
Wellington Management	United States	553
Permal Asset Management	United Kingdom	336
Deutsche Asset Management	Germany	134
Gulf International Bank	Bahrain	122
Pictet & Cie	Switzerland	98

Source: John Bauer (SAMBA Capital Management), 'Islamic equity funds: investment and marketing issues for fund managers', paper presented to *The International Islamic Finance Forum*, Dubai, 18 March 2002.

Table 6.7: Five largest Islamic fund sponsors

Sponsor	*Country*	*Assets, $ million*
National Commercial Bank	Saudi Arabia	935
SEDCO	Saudi Arabia	336
Keppel Insurance	Singapore	98
The International Investor of Kuwait	Kuwait	83
Rashid Hussain Berhad (RHB) Unit Trust Managers	Malaysia	57

Source: John Bauer (SAMBA Capital Management), 'Islamic equity funds: investment and marketing issues for fund managers', paper presented to *The International Islamic Finance Forum*, Dubai, 18 March 2002.

To be viable and cover their costs in the longer term, managed funds typically need to have assets under management of at least $50 million. Only three of the 105 Islamic funds are in that category at the time of writing, but the industry is new and much will depend on how much funding they attract during the upturn of the next economic cycle when international markets recover. Funds administered from Malaysia and the Gulf have lower administrative costs than those managed from major international financial centres such as London. However, as much of the money is invested in Western markets, those with knowledge and experience of these markets are usually the best managers. Therefore, many Islamic funds are promoted by leading Western fund management groups, Wellington of the United States being the market leader in terms of assets managed, as Table 6.6 shows.

Wellington manages the Al-Ahli Global Trading Equity Fund and the much smaller Al Kawthar Fund promoted by the National Bank of Kuwait, as well as the Caravan Fund promoted by the Commercial Bank of Qatar. They also manage their own Hegira Global Equity Fund, but most of their Islamic fund assets derive from their links with the National Commercial Bank. Permal, a London subsidiary of Worms & Cie, a Paris-based conglomerate that grew out of a Swiss private wealth management group, look after the Alfanar Funds on behalf of SEDCO. Permal Asset Management is based in the United States, but it is the London subsidiary that manages the Alfanar Funds, although the latter are incorporated for tax and regulatory purposes in the British Virgin Islands. Deutsche Asset Management handle the secured funds offered by the National Commercial Bank, one of which is global and the other focused on European investment. Gulf International Bank is the only Arab-based fund manager of significance, as it manages the National Commercial Bank's Al-Ahli Asia Pacific and European Equity Funds. Wisely, the policy of the National Commercial Bank is to engage several Western fund managers so that their relative performances can be assessed on behalf of their Islamic investors.

As Table 6.7 shows, the only other institution apart from the National Commercial Bank that has enjoyed success in attracting high-value investments into Islamic funds is SEDCO. This company is largely owned and managed by the Bin Mahfouz family, who were the founders and main owners of the National Commercial Bank until its takeover by the Saudi Arabian government and management reorganisation in 1997. This followed the departure of Khalid Bin Mahfouz, Osama Bin Laden's brother-in-law, who was accused of misuse of his position and being involved with Islamic militants and doubtful religious charities.[18] Khalid Bin Mahfouz was stripped of his Saudi Arabian citizenship while abroad but he had already acquired Irish citizenship in 1990 under a dubious deal involving the sale of passports under former Prime Minister Charles Haughey that is being investigated by the Moriarty Tribunal[19] and the Flood Enquiry.[20]

SEDCO was established in 1976, but it was largely concerned with distribution, equipment leasing and real estate management.[21] Since 1998, it has become more involved in investment management and the ambition of its chairman, Mohammad Bin Mahfouz, is for the company to become the premier Islamic investment institution. With assets of over $336 million already under management, it has made significant progress in this direction.

There have been three reactions by the Islamic fund management industry to the global stock market volatility of 2000 and 2001. The first is increased interest in a more diverse range of markets, including those of Muslim countries, with more domestic Islamic funds being marketed to local citizens. The second consequence is, as already noted, more interest in Islamic equity funds with lower risks that aim to produce a reasonable dividend stream, rather than focusing on capital growth. Such funds invest in utilities or retailers rather than high technology companies, and are less subject to price volatility. Islamic funds of this type include the Al-Rajhi Balanced Funds, the Al-Ahli Secured Funds offered by the National Commercial Bank, the Al Hilal Fund promoted by the Abu Dhabi Islamic Bank and the Faysal Shield Fund offered by the Shamil Bank of Bahrain.

The third reaction has been the emergence of more Islamic funds that are either based on Islamic bonds or on investment in real estate or other forms of property. The returns from property investments derive from the rental income, which is usually more stable than dividend income. There would also appear to be scope for the development of 'with profits' bonds, similar to those offered by insurance companies in the West, where returns are linked to equity performance but there is a degree of protection from downside risks. Bonuses, once declared, cannot be taken away but do not fully reflect capital gains and dividends payable. There is a revisionary bonus paid on maturity but penalties for early exit, usually within a five-year period. Islamic 'with profits' bonds may appeal to many Muslim investors investing for the medium term in uncertain financial conditions, providing they are prepared to sacrifice liquidity.

In the aftermath of the events of September 11th and the tragic consequences for Afghanistan and the Palestinians, there is a desire by Islamic investors to rethink their strategies for asset management and, if possible, to do more to help their fellow-believers in the Muslim World. Translating preferences into realities is not so easy, but as change can come in the longer term it is instructive to examine the flows from the Gulf to two Muslim markets to illustrate the opportunities and difficulties.

PORTFOLIO INVESTMENT FLOWS FROM THE GULF INTO EGYPT AND MALAYSIA

It is unlikely that there will be a sudden flood of Gulf funds into markets such as those of Egypt or Malaysia, as there are restrictions on capital movements out of both countries which deter inward investors, and Egypt's ability to maintain the value of its currency is questioned as the tensions since September 11th have caused tourists to think again about visiting the country, with arrivals well down on 2000 and fewer advance bookings. Around 20 per cent of Egypt's hard-currency earnings are accounted for by tourism, mostly from Europe and the United States.

There is only one specialist Saudi Arabian fund that invests in Egypt, the Al-Rajhi Egyptian Fund that is managed by EGF Hermes in Cairo, although the Al-Rajhi Middle Eastern Fund also has around 22 per cent Egyptian exposure, the other major investments being in Turkey and Saudi Arabia (22 per cent each), and Jordan, Morocco, Lebanon and Bahrain (8.5 per cent each).[22] Both these Al-Rajhi funds are small, with a mere $10 million each under management. The Al-Ahli Arab Equity Fund offered by the National Commercial Bank of Saudi

Arabia invests in Egypt and other Arab League countries, but this is not marketed as an Islamic fund, and there is no screening of investments for *shari'a* compatibility.

There is no specialist Islamic fund in the Gulf focused on Malaysia or Indonesia, although the Al-Ahli Asia Pacific Trading Equity Fund, which is offered by the National Commercial Bank, and managed by the Gulf International Bank, does have some exposure to the Kuala Lumpur market. The Al-Ahli South East Asia Fund has even greater Malaysian exposure, but it is not a designated Islamic fund. The Arab-Malaysian Unit Trust has marketed the Tabung Ittikal Arab-Malaysian Fund to Gulf investors since 1993, but the trust has no Gulf presence, its offices being in Kuala Lumpur.

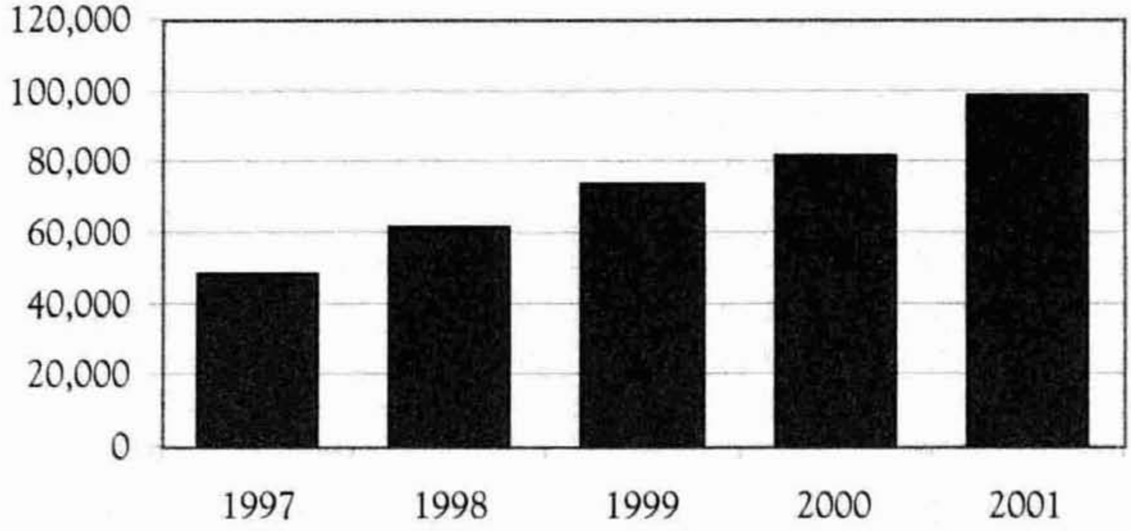
LOCAL INVESTMENT IN THE SAUDI ARABIAN MARKET

The major investment in Muslim markets is simply domestic investment with Saudi Arabians and Malaysians investing in Islamic funds that offer a portfolio of local stock that has been screened for *shari'a* compliance. If investors have future anticipated liabilities in riyals or ringitt, then they will also want to have assets denominated in these currencies. The banks or fund promoters also have an advantage in their local markets, as they can manage the funds themselves, given their knowledge of their own market, rather than relying on international banks or fund management groups.[23] Leading local Islamic funds in Saudi Arabia include the Al-Rajhi Local Share Fund, the Al-Ahli Saudi Riyal Murababaha Trading Fund and the Al-Ahli Saudi Trading Equity Fund marketed by the National Commercial Bank,[24] the Riyadh Equity Fund marketed and managed by the Riyadh Bank and the Al Arabi Saudi Company Shares marketed by the Arab National Bank.

As Figure 6.2 shows, there has been a very rapid rise in the numbers of investors in Saudi Arabian mutual funds in recent years, with almost 100,000 individual investors participating by 2001, more than double the 1997 figure. Most of these investors are bank clients with current accounts who are reluctant to open savings accounts that earn an interest-based return. Bank clients could, of course, switch to the Al-Rajhi Banking and Investment Corporation, which provides investment accounts on a *mudaraba* basis, but in practice there is much bank account inertia in Saudi Arabia, as in most other countries. Furthermore, even within Al-Rajhi, most clients simply have current accounts that yield no return.

The National Commercial Bank has played the leading role in Saudi Arabia's mutual fund industry since the 1980s and it accounts for over half of the total funds under management. Its first fund was launched in 1979, the Al-Ahli Short Term Dollar Fund. It largely invested in United States government securities and highly rated corporate bonds, and was conventional rather than Islamic in

Figure 6.2: Numbers of investors in Saudi Arabian mutual funds



Source: National Commercial Bank, *Market Review and Outlook*, Jeddah, 1 February 2002, p. 5.

character, as returns were interest-based. In 1987 the National Commercial Bank launched its first Islamic fund, the Al-Ahli International Trade Fund, which provided investors with capital preservation but an income stream from short-term *murabaha*-based trade transactions. This was, to some extent, a response to the change in status of the Al-Rajhi to a banking and investment corporation providing Islamic financial services, as the National Commercial Bank, as the leading bank in the Kingdom, also wanted to stress its Islamic credentials, even though it was a conventional bank.

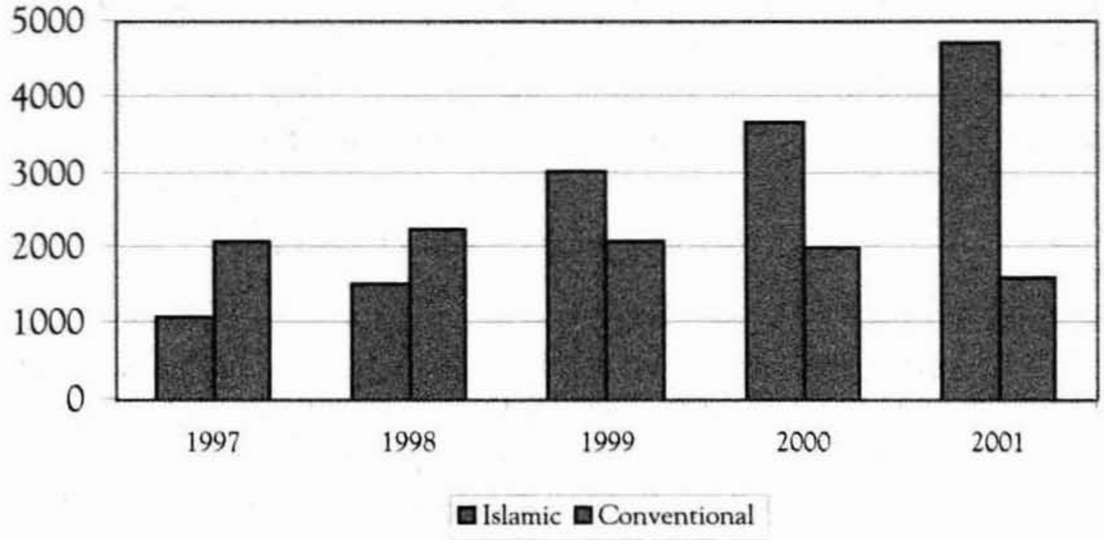
As Table 6.8 shows, the total assets of Saudi Arabia's managed funds amounted to almost $10.7 billion by 2001, of which $4.6 billion was categorised as non-interest – or, in other words, Islamic. The assets of Islamic-designated managed funds exceed that of any other single category, with the Al-Ahli Global Trading Equity Fund offered by the National Commercial Bank being the largest Islamic mutual fund in the world, with funds of over $640 million under

Table 6.8: Saudi mutual funds, 2001

	Assets, $ million	*Investors*	*Funds*
Bonds	46	434	10
Money market	2,490	27,680	19
Non-interest	4,616	44,107	18
International stock	2,969	23,232	57
Local stocks	324	1,216	12
Total	10,687	99,147	13

Source: National Commercial Bank, *Market Review and Outlook*, Jeddah, 1 February 2002, p. 6.

Figure 6.3: Islamic *versus* money market funds in Saudi Arabia, $ million



Source: National Commercial Bank, *Market Review and Outlook*, Jeddah, 1 February 2002, p. 5.

management. The value of the units in the fund has doubled since inception in January 1995, although there was a loss of 20.9 per cent in 2000 and a marginally smaller loss in capital values in 2001. The last profitable year was 1999, when the units increased in value by 27.3 per cent. The Al-Ahli Global Trading Equity Fund has two-thirds of its investments in the United States and around one-quarter in Europe, with the remainder in Japanese equities.

Although the Al-Ahli Global Trading Equity Fund has the largest assets, most of the Islamic funds in Saudi Arabia are based on short-term trading instruments, usually *murabaha* mark-up contracts or *salam* commodity sale contracts. It is meaningful, therefore, to compare Islamic fund assets with those of money market funds, given their emphasis on income and liquidity. Figure 6.3 shows that the value of Islamic funds exceeded that of money market funds by 2001, the latter category being the least acceptable from an Islamic perspective, given the interest-based nature of the income. The Al-Ahli International Trade Fund has been the most successful of the Islamic funds that were viewed in Saudi Arabia as an acceptable alternative to money market funds. It largely invests in metals and soft commodities, with an annual fee of only 0.75 per cent, but with a high minimum investment of over SR 250,000 ($66,667). Returns are paid monthly directly into investors' bank accounts. Although non-interest based, returns fell from 4.81 per cent in April 2001 to 3.96 per cent in June, and by September were below 3.8 per cent.

The largest local equity fund in Saudi Arabia is the Al-Ahli Saudi Trading Equity Fund. Its aim is to produce capital growth through investment in Saudi-listed stock, mostly in industrial and cement production, with this actively managed fund applying a higher management charge of 1.75 per cent annually, but with a relatively modest minimum investment of SR 5,000 ($1,333). The Al-Ahli Saudi Trading Equity Fund has over SR 30 million ($8 million) under management, making it the largest local fund in the Kingdom, although its size is modest compared to that of Islamic global funds. It has produced a return of 22 per cent since its inception in 1998, and a return of 6.1 per cent for 2000.

LOCAL INVESTMENT IN MALAYSIA

In Malaysia, the leading local Islamic managed fund is the RHB Mudarabah Fund that has been operating since 1996. This is the largest Islamic fund in Malaysia, with over RM 194 million ($51 million) being managed on behalf of 2,800 investors.[25] Almost 10 per cent of its funds are invested in Telekom Malaysia, a further 10 per cent in local technology stock and a third in diverse trading services, with 7 per cent in both property and construction. The timing of the launch of the fund was unfortunate, immediately prior to the 1997 crisis, and the fund has lost over 20 per cent of its value since inception. In 1999, there was a return of over 36 per cent, but this was followed by a capital loss of almost a quarter of the fund's value in 2000. The other significant local fund in Malaysia is the Amanah Saham Bank Islam Fund, which has been successfully promoted by Bank Islam Malaysia to its own depositors as an investment vehicle that can result in capital appreciation. Unfortunately, it is difficult to outperform the market, and investors in this fund, which was instigated in 1994, have fared less well in recent years than prior to the Asia financial crisis.

As local Islamic investors in Malaysia have been deterred by the poor performance of the Kuala Lumpur Stock Exchange, three of the fund management groups have launched Islamic bond funds that aim at capital preservation and a regular non-interest based income. The Islamic bond market in Malaysia developed in the 1990s with the issue of government and then corporate notes based on *al bai bithamen ajil*, the sale of goods on a deferred-payments basis. Usually the notes were issued to cover equipment financing, the client settling by instalments that provided the income stream on which the security could be based. Although there are objections in the Gulf amongst *shari'a* scholars to *bai al dawn*, the sale of debt, as it is argued that those owing money should know their creditors, in Malaysia it is argued that as long as those being financed know in advance their debts will be traded, the issue of debt securities is legitimate.

The RHB Islamic Bond Fund was launched in Malaysia in August 2000, with a minimum subscription of only RM 1,000 ($265), a single buying and selling price, no entry fees and disbursements of dividends twice each year. Total dividends of 6 per cent were paid out during the first year of operation, and the fund attracted over RM 14 million ($3.7 million) from 400 investors during the first six months of its operations.

IDENTIFYING THE BEST PERFORMING FUNDS

Investors in Islamic mutual funds have to identify their financial objectives when deciding what funds to invest in, as some may want low-risk investments, capital preservation and a regular income from their funds, while others may be prepared to accept a higher level of risk in anticipation of capital gains, with much less stress on income. Age and family commitments may be important factors in determining attitudes towards risk and returns, as clearly it would be foolish for an investor with a modest income and many financial outgoings to invest heavily in high-risk technology stock or volatile emerging markets.[26]

The reference points for price performance for Islamic investments are increasingly the Islamic indices provided by the FTSE and Dow Jones.[27] FTSE has a global Islamic index with sub-components for the Americas, Europe, the Pacific Basin and South Africa, while the Dow Jones has its general Islamic market index, with more focused indices for the United States, Canada, Asia/Pacific, Europe and the United Kingdom.[28] In addition to its geographical indices, the Dow Jones has Islamic indices for technology stock and extra liquid securities. Both FTSE and Dow Jones screen out stock whose core activities are related to conventional interest-based banking, alcohol, tobacco, gaming, insurance, pork production (and pork distribution), or other activities deemed offensive under Islamic law. A financial screen is also applied, as companies are excluded if their interest-bearing debt-to-assets ratio is equal to or greater than one-third. The Islamic objection here is that companies that are too heavily dependent on *riba*-based financing should be excluded, but that some dependence is permitted on pragmatic grounds, otherwise there would be no acceptable companies to invest in.[29]

In practice, the movements of Islamic indices is closely in line with their conventional counterparts, the major exclusions affecting performance being the stocks in conventional banks. When bank shares are doing well, there is an underperformance of the Islamic share universe, and when the conventional banking sector is performing relatively badly, the converse occurs. It is arguably appropriate to use these indices to compare the performance of Islamic dollar-denominated global equity funds, but they are not relevant for looking at the performance of equity markets in Muslim countries.

The more relevant indices for these purposes are the Standard and Poors International Finance Corporation (S&P/IFCI) emerging market indices for Muslim economies, as shown in Table 6.9, which cover Egypt, Indonesia, Malaysia, Morocco and Turkey. As the table shows, 2001 was disappointing for all these markets, but 2002 saw a marked recovery in Malaysia and Indonesia. Egypt was emerging market of the year in 1999, but subsequent performance has been poor. Saudi Arabia is not included in these indices, as foreign portfolio investment flows into the Kingdom are not permitted, with the exception of

Table 6.9: S&P/IFCI price indices for Muslim emerging markets, %

	2001	*January to June 2002*
Egypt	–35.1	–3.2
Indonesia	–12.0	71.2
Malaysia	–7.8	15.2
Morocco	–14.7	–9.9
Turkey	–64.2	–23.4

Source: www.spglobal.com/indexmainemdb2000.html

those from other GCC countries, in line with a policy of maintaining local ownership of companies. Non-GCC investors can only invest indirectly in Saudi Arabia by purchasing shares through specialist Saudi funds, the Saudi American Bank being the sole provider of such a fund at the time of writing. The Saudi American Fund is not classified as Islamic.

In many respects, the Saudi Arabian stock market is, with Malaysia, one of the two most interesting in the Islamic World because of its size. The capitalization of the market exceeds $100 billion, and there are 76 listed companies. This means it is the largest market in the Middle East, with the value of stock exceeding that of even the Russian market. A new electronic trading system, *Tadawul*, started functioning on 6 October 2001, enabling customers of the Kingdom's ten commercial banks to trade at most branches throughout the country.[30] The market index rose by 11 per cent in 2000, and although in 2001 conditions were less favourable, with a modest fall in prices, the rise in trading volumes from January to the end of September exceeded 39 per cent.[31] The post-September 11th period witnessed gains for Saudi Arabian shares as modest amounts of capital were repatriated, with the market reaching an all-time high by June 2002, but prices subsequently fell back owing to increasing uncertainty during the build-up to the war against Iraq.

CONCLUSIONS

The Islamic mutual fund industry is largely focused on Western stock markets, rather than the emerging markets of the Muslim World. The flow of funds mirrors that of high net worth individuals from Saudi Arabia and the Gulf; indeed, those of more modest means are more likely to be risk-averse and wish to have their funds invested in more mature Western markets, rather than Muslim emerging markets.

There is, nevertheless, much political disillusionment amongst Saudi Arabian and Gulf nationals with the United States following the war in Afghanistan and the deterioration in the situation of the Palestinians. In addition, the harassment of Saudi Arabian and Gulf students in the United States since 11 September 2001, many of who come from wealthy families, has fuelled resentment. The freezing of bank accounts and other financial assets of those who are not involved in any way in supporting terrorism has also, inevitably, caused much antagonism.[32] Often this has arisen because of mistaken identities and confusion over names, as many in Saudi Arabia and the Gulf have similar or even identical names, but such explanations are seen as just another manifestation of Western ignorance.

Fund managers and private bankers have noticed an increasing coolness towards investment in the West, and the United States in particular, amongst their Gulf clients since October 2001; but although there is a desire to invest in other Muslim countries and at home, the financial constraints remain for the reasons illustrated here with respect to Egypt, Malaysia and Saudi Arabia. There may be increasing flows of official development assistance through the IDB, but the ending of private capital flight and the repatriation of funds invested in the West will only occur if present hostilities remain for a protected period of years. Ironically, the position is even more difficult for Islamic funds, as conventional bank shares are dominant in Muslim stock markets in Saudi Arabia, the Gulf and Jordan. Holding such shares is *haram*, as far as investors are concerned who wish to respect *shari'a* law.

NOTES

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16. For a discussion of some of these issues, see the proceedings of the Islamic mutual funds conference held at the University of London's School of Oriental and African Studies in November 2001, www.Islamic-banking.com/lectures/conf_soas_report.php#top
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18. Kevin Dowling, 'The ties that bind: Barclays, a bin Laden relative, Carlyle and the BCCI boys', *Online Journal*, 3 November 2001.
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